

**H.R. 920**  
**The Multiple Peril Insurance Act**  
**Of 2007**

**Written Testimony of**

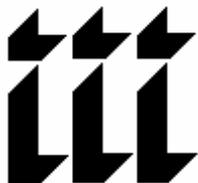
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*United States House of Representatives Committee*  
*on Financial Services*  
*Subcommittee on Housing and Community Opportunity*

Washington, D.C.

July 17, 2007

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Good afternoon Chairwoman Waters, Ranking Member Biggert and members of the Committee. My name is Robert Hartwig and I am President and Chief Economist for the Insurance Information Institute, an insurance trade association based in New York City whose primary mission is to improve the public's understanding of insurance: what it does and how it works. Our members consist of insurers and reinsurers that operate on a global scale and account for more than 60 percent of the premiums written in the United States.

Thank you for the opportunity to appear before the Committee today to discuss the economic, financial and fiscal ramifications associated with the expansion of the National Flood Insurance Program (NFIP) to cover wind losses as proposed under H.R. 920, *"The Multiple Peril Insurance Act of 2007."* Let me begin by assuring the Committee that the insurance industry is committed to finding innovative solutions to the real and growing threat posed by catastrophic windstorm and floods in the United States.

My testimony today will address five major issues:

- The true scope of windstorm exposure in the United States and the potential fiscal consequences should H.R. 920 fall short of its stated requirement that rates be "actuarially based";
- The historical difficulties that government operated property insurers have encountered in implementing a rating system that is actuarially sound;
- The distortionary incentive effects an expanded program could have on property owners and communities—likely leading to increased and accelerated development in environmentally sensitive areas vulnerable to flood and wind risk;
- The importance of recognizing that even if rates are actuarially sound, H.R. 920 does not correct the fundamental problem of inadequate flood insurance penetration rates; and
- The fact that the ability of the NFIP to offer windstorm coverage at actuarially sound rates as required by H.R. 920 will be undermined by political decisions

by many state-run property insurers to subsidize windstorm coverage, thereby pricing federal coverage out of the market.

### **The Scope of Wind Exposure in the United States**

In many parts of United States, wind is the most frequent and costly cause of catastrophic loss. Consequently, any federal government program established to assume windstorm risk anywhere in the United States must be prepared to adjust, manage and pay losses of a scale and magnitude that are without precedent.

As Figure 1 shows, wind losses can arise from many types of disaster. In fact, wind plays a role in approximately 80 percent of the catastrophe losses paid by insurers. Tropical events (hurricanes and tropical storms) accounted for \$132.3 billion or nearly half of the \$278.4 billion in insured catastrophe losses over the 20 year period from 1986 through 2005. Tornadoes accounted for another one-fourth of that total or \$68.3 billion. Billions of additional wind-related losses arise in the context of severe winter storms (such as Nor'easters) and storms with strong winds not associated with tropical or tornadic events. Collectively, such events accounted for \$29.6 billion in insured losses between 1986 and 2005 or 10.6 percent of total catastrophe losses. The destructive effect of high winds from catastrophic events is often compounded by damage from wind-driven rain, hail, snow and ice. It should be noted that the statistics cited here apply exclusively to officially designated catastrophes, which are defined as events resulting in losses of at least \$25 million. Hundreds of thousands of claims and many billions of dollars are paid by insurers each year as the result of windstorm events that fall beneath this threshold.

The purpose of the preceding analysis is twofold. First, it is clear that catastrophic windstorm losses occur frequently, are ubiquitous and can be extremely costly. Second, it is important to point out that the vast majority of windstorm losses today are paid by private insurers, including in coastal areas. Efficient and prudent management of wind related exposures takes considerable experience and significant financial, technical and human resources.

## **Historical Difficulties Encountered by Government Operated Property Insurers**

Since the 1960s a myriad of different government programs in place across the U.S. have provided property insurance to high risk policyholders who, for a variety of reasons, may have difficulty obtaining coverage from the standard market. The National Flood Insurance Program is perhaps the largest and best known federal program. Many states operate so-called residual, shared or involuntary market programs that make basic insurance coverage more readily available.

There is no question that government operated insurers play a vital and necessary role as insurers of last resort, servicing hard to place risks and acting as “safety valves” following major catastrophic events. But today, many residual property market plans have evolved away from their original design as small insurers focused primarily on relatively low insured-value urban properties into major providers of insurance in high-risk, high value coastal areas. Many operate at deficits, or slim positions of capital, even in years with light catastrophe losses. A variety of factors are at play here, including the fact that government run property insurers are highly susceptible to political pressure and manipulation and frequently are not permitted to charge rates or adopt underwriting criteria that are commensurate with the risk being assumed. The tendency of regulators and/or legislatures to suppress rates in the private sector is a major contributing factor to pull-backs by private insurers in many coastal areas. This leads directly to more property owners seeking coverage through the state’s residual market facility and more pressure on politicians to keep rates down irrespective of the risk, the magnitude of losses or the deficits incurred.

While H.R. 920 requires that rates be established on an “actuarial basis,” government operated insurers have historically had very little success in realizing that goal. The financial consequences have been nothing short of disastrous. The National Flood Insurance Program itself currently has a deficit of \$17.5 billion according to the Congressional Budget Office.<sup>1</sup> Of the 31 state-run Fair Access to Insurance Requirements (FAIR) plans for which data are available, 26 have incurred at least one operating deficit

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<sup>1</sup> Congressional Budget Office, “*Value of Properties in the National Flood Insurance Program*,” Publication No. 2925, June 2007.

since 1999.<sup>2</sup> Of the seven Beach and Windstorm plans for which data are available, all have sustained at least one underwriting loss since 1999.<sup>3</sup>

In the course of the last decade the FAIR Plans have seen a more than 50-fold ballooning of their aggregate operating loss, from a \$51.9 million loss in 1995 to a \$2.8 billion deficit in 2005. Thus, not only have government run property insurers typically found operating on an actuarially sound basis elusive, the plans have generally grown in size over time as has the size of the deficits they incur. Given this real-world experience, it is unclear what practical safeguards—beyond language in the bill itself—could or would be implemented as part of H.R. 920 that would prevent deviation from actuarially sound pricing practices and the ensuing taxpayer-funded bailouts.

### **Economic Consequences of Failing to Price on an “Actuarial Basis”**

Much of the debate surrounding the failure of government run plans to charge actuarially sound rates focuses on the deficits that invariably result. But as multi-billion dollar deficits become more commonplace, the size of the policyholder assessments, and tax levies needed to close those deficits, will necessarily grow. The fact that there are frequent and large deficits at all suggests that the rates are not presently actuarially sound. But from an economic perspective, the issue of who ultimately pays for those deficient rates is at least as important as their size.

At the federal and state level, legislators and regulators have almost universally chosen to sacrifice actuarially sound rating and underwriting practices and fiscal prudence for political reasons. Though popular with voters, the decision to effectively subsidize coastal dwellers has financially grave consequences and sends perverse signals about risk to the marketplace. Specifically, the combination of artificially low rates and underwriting criteria that are too lax is financially lethal, enabling and encouraging rampant and substandard development in vulnerable coastal areas far beyond what would

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<sup>2</sup> Over the period from 1999 through 2005. Includes states with no hurricane exposed coastline.

<sup>3</sup> For more detail on the financial performance and operational details of residual market plans, see “*Residual Market Plans: From Markets of Last Resort to Markets of First Choice*,” Insurance Information Institute, June 2007, at <http://www.iii.org/media/research/residualmarket/>.

occur if property owners were required to internalize the true cost of risk in their decisions to build and buy property in coastal zones.

Financing the deficits that emerge poses an unpalatable dilemma for legislators. Should coastal dwellers be required to pay more to bring rates to an actuarially sound basis? Should the government refuse to insure properties that are simply too risky to underwrite at any price? These are politically unpopular and hard decisions, which is precisely the reason why they are seldom made. Consequently, legislators tend to search for ways to spread the cost of financing deficits well beyond the policyholders who actually incur the losses. Over time, state legislatures have authorized deficits to be financed by assessments on not only their own policyholders, but the policyholders of all insurers in the state. Moreover, assessments can be levied on property owners who have never filed a claim, including those who live far from the coast as well as people who have taken every precaution to mitigate against storm damage. Even auto insurance and commercial liability policies can be assessed. General tax revenues and even federal disaster aid are sometimes diverted to offset deficits in order to lessen assessments, thereby spreading the losses to all taxpayers including those who own no property and the poor. Borrowing is also common. When money is borrowed and paid back over an extended timeframe, losses are spread intertemporally (across time), forcing future residents—people who are now children and generations yet-unborn—to shoulder part of the burden. The total cost of financing the disaster is greatly increased as well. One billion dollars borrowed at the June 2007 state and municipal bond rate of 4.6 percent for a term of 30 years would ultimately cost policyholders and/or taxpayers \$1.85 billion when interest charges are factored in.

Practical experience has demonstrated repeatedly that government-run property insurers have rarely operated on an actuarially sound basis and for political reasons are unlikely to do so in the future. The effect is to enable and encourage rapid development in vulnerable areas that will inevitably drive up the size of future deficits, financed to a great extent by policyholders and taxpayers unconnected to the events that actually gave rise to the loss, perpetuating a vicious and expensive cycle.

Moreover, these subsidies have encouraged the development of environmentally fragile areas now threatened by a climate of increasingly frequent and severe storms.

### **Will Adding Wind Coverage to NFIP Policies Really Solve the Problem?**

A fundamental question to ask is whether expanding the NFIP to include optional windstorm coverage will solve the problem associated with discerning wind from water damage. There are several reasons to suspect that it will not:

- **Low Flood Insurance Penetration Rates:** Penetration rates for flood coverage, even at subsidized rates, are low. Just 49 percent of homeowners in flood zones purchase flood coverage. Only 1 percent of homeowners outside those zones have coverage [Figure 2]. In coastal Mississippi, for example, an area that had suffered significant flood and wind damage from storms predating Hurricane Katrina, fewer than 20 percent of homeowners in coastal counties had flood insurance when Hurricane Katrina struck [Figure 3]. The biggest single factor that gave rise to coverage disputes in the wake of Hurricane Katrina was the lack of flood coverage.
- **Consumers Generally Skip Optional Coverages:** Because the wind coverage provision in H.R. 920 is optional and because flood insurance for most homeowners is also optional, the take-up rate for the combined product is likely to be even lower than for flood insurance alone. As a general rule, homeowners tend to pass on optional coverages. This is true today with flood insurance offered through the NFIP, despite that fact that it is offered at highly subsidized rates. Another prominent example of low take-up rates for optional coverage is earthquake insurance, which is purchased by just 12 percent of California homeowners.
- **Subsidies Offered by State-Run Insurers Will Price H.R. 920 Windstorm Coverage Out of the Market:** Few property owners will buy windstorm coverage through the NFIP because H.R. 920's requirement to price the coverage on an actuarial basis will result in rates that in many cases will be far

above the heavily subsidized rate many property owners receive through their state's residual market facility. Florida's Citizens Property Insurance Corporation, for example, in 2006 became the state's largest insurer of homes and is growing rapidly today in large part because the state has decided to subsidize every new policy written, putting it in direct competition with the private market. Despite having accrued deficits over the 2004/2005 hurricane seasons totaling \$2.3 billion, Governor Charlie Crist early this year ordered that Citizens' rates be rolled back and then frozen through 2008. Florida Citizens currently has 1.3 million policyholders and more than \$600 billion in insured exposure. It is receiving 25,000 new applications per week and expects to reach 1.7 million policyholders by December and more than 2 million in 2008.

## **Summary**

In many parts of the United States, wind is the most frequent and costly cause of catastrophic loss. Consequently, the proposed expansion of the National Flood Insurance Program to provide windstorm coverage as specified under H.R. 920 is a risky and potentially enormous financial undertaking. It is easily the most significant change in the program since its inception in 1968. Though H.R. 920 expressly requires that rates be determined on an "actuarial basis," the history of government operated property insurers is one of chronic deficits. Anything short of rates that fully reflect the true risk of windstorms will produce economic incentives that contribute to excessive and unsound development in environmentally sensitive areas vulnerable to windstorm and flood risk and, ultimately, higher property losses, deficits, assessments and taxes. Yet even if rates are actuarially sound, H.R. 920 may never achieve its objective of providing a multi-peril policy because of the longstanding, fundamental fact that penetration rates for flood insurance remain woefully low in many areas where the twin perils of windstorm and flood are common. Because windstorm coverage under H.R. 920 is optional, experience suggests that few consumers will purchase it. Finally, political decisions by states to subsidize coastal property insurance rates imply that the price of windstorm coverage

offered through the NFIP at actuarially sound rates will be non-competitive from the perspective of most coastal residents. In other words, few property owners who could benefit from a multi-peril policy as envisioned by H.R. 920 would have the economic incentive to purchase such a policy.

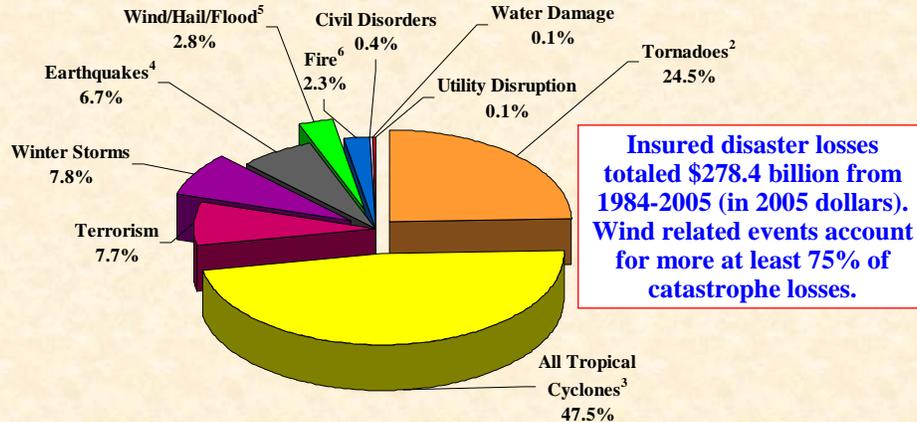
To conclude, the insurance industry is committed to working in partnership with public policymakers, consumers and business in developing fact-based solutions to the formidable challenge posed by windstorms and floods and continuing our tradition of helping families, businesses and communities wherever and whenever disaster strikes.

Thank you for the opportunity to address the Committee today. I would be happy to address any questions you might have.

Figure 1.



## Inflation-Adjusted U.S. Insured Catastrophe Losses By Cause of Loss, 1986-2005<sup>1</sup>



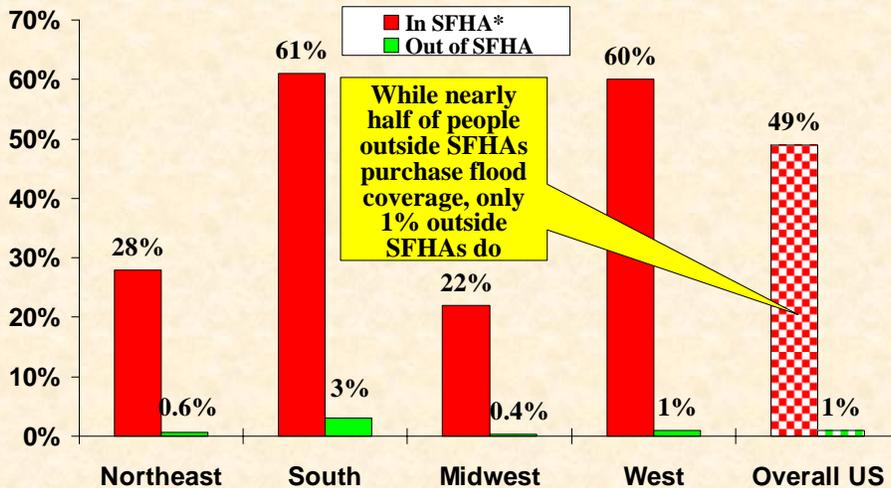
<sup>1</sup> Catastrophes are all events causing direct insured losses to property of \$25 million or more in 2005 dollars. Catastrophe threshold changed from \$5 million to \$25 million beginning in 1997. Adjusted for inflation by the III.  
<sup>2</sup> Excludes snow. <sup>3</sup> Includes hurricanes and tropical storms. <sup>4</sup> Includes other geologic events such as volcanic eruptions and other earth movement. <sup>5</sup> Does not include flood damage covered by the federally administered National Flood Insurance Program. <sup>6</sup> Includes wildland fires.

Source: Insurance Services Office (ISO)..

Figure 2.



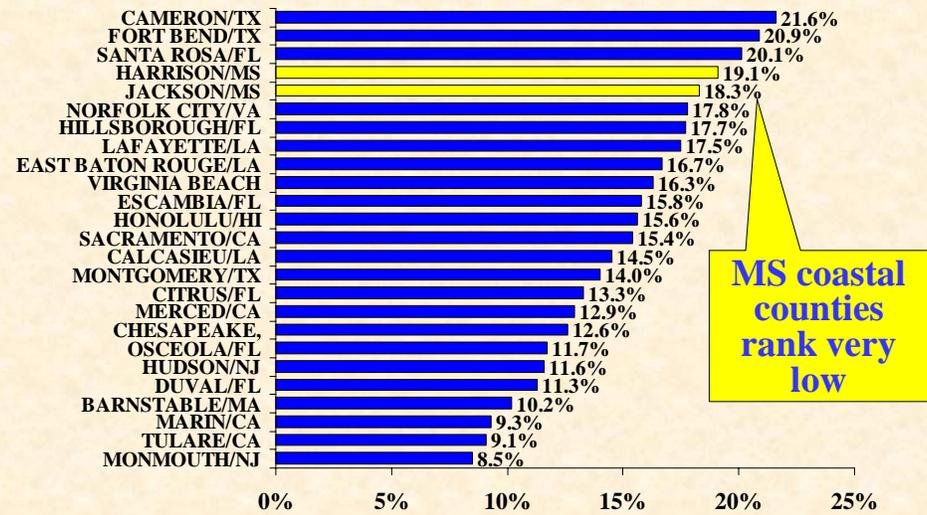
## NFIP Flood Policy Penetration Rates, by Region



\*Special Flood Hazard Areas.

Source: *The National Flood Insurance Program's Market Penetration Rate: Estimates and Policy Implications*, RAND, 2006.

Figure 3. *Flood Insurance Penetration Rates:  
Counties/Parishes Ranked 51-75\**



\*As of 12/31/05.

Source: New Orleans Times-Picayune, 3/19/06, from NFIP and US Census Bureau data.